BRIEF FOR PETITIONER.

Opinions Below.

The Commissioner of Internal Revenue on February 20, 1939, determined that petitioner was subject to tax for the years 1930, 1931, 1932 and 1933 amounting to $3,008.99 and made an additional assessment against said hospital in said amount, and penalty of $752.25.

The opinion and decision of the Court of Appeals for the District of Columbia is reported in 125 Federal Reporter, Second Series, page 553.

Statement of Jurisdiction.

The case is presented to this Court on petition for writ of certiorari to review a decision of the United States Court of Appeals for the District of Columbia under Section 240 (a) of the Judicial Code (28 U. S. C. A. 347; 45 Stat. 938).

The Commissioner of Internal Revenue on February 20, 1939, determined that petitioner was subject to tax for the years 1930, 1931, 1932 and 1933 amounting to $3,008.99 and made an additional assessment against said hosiptal in said amount, and penalty of $752.25.

An appeal was taken to the Board of Tax Appeals May 17, 1939 (R. 3) under Section 272 of the Revenue Act of 1928 and 1932 and upon hearing, a judgment was entered for the Commissioner on October 25, 1940 (R. 16). January 2, 1941 a petition for review of said decision was filed in the United States Court of Appeals for the District of Columbia (R. 17) under the Revenue Act of 1926, Section 1002 (b), 1003 (a) (44 Stat. 110) as amended by the Revenue Act of 1934, Section 519 (a) (48 Stat. 760). The court affirmed the Order of the Board of Tax Appeals February 2, 1942.

Statement of the Case.

St. Francis Hospital was indebted to the Union Trust Company on a mortgage and single bond accompanying the same executed by the Sisters of the Third Order of St. Francis and assumed by St. Francis Hospital. The mortgage contained the usual covenant to pay interest without deduction of income tax up to 2%; and each semi-annual installment of interest was paid in a single check to said trust company (R. 21).

After the delivery of the mortgage and bond to the trust company, said trust company executed and retained in its files a "Declaration of Trust" (R. 23) wherein it certified that the "mortgage and its accompanying bond, and all moneys secured thereby, are held in trust for the several estates interested therein to the extent of the contribution of each of said trust estates towards the principal thereof, as shown by the books of original entry, ledgers, vouchers, cards and other records of the trust department pertaining thereto." This "Declaration of Trust" was not recorded, and no notice thereof was given to petitioner.

As the trust company had available funds of various estates for which it was fiduciary, portions of the said mortgage and bond were allocated on the books of the trust company to such various estates "for which it was guardian, trustee, agent or other fiduciary, by notation upon its records that said funds of these estates were invested in said mortgage" (R. 21).

After the interest had been paid to the Union Trust Company, it distributed on its books among these estates such portions of the interest payment as were applicable to such estates by reason of the allocation of their funds to said mortgage.

The Union Trust Company is a domestic corporation (R. 22).

Section 144 of the Revenue Act of 1928 (45 Stat. 833) and Section 143 of the Revenue Act of 1932 (47 Stat. 215) are in part as follows:

"Sec. 144. WITHHOLDING OF TAX AT SOURCE.

(a) Tax-free covenant bonds.—

(1) REQUIREMENT OF WITHHOLDING.—In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods, if payable to an individual, a partnership, or a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein."

Specification of Error by the United States Court of Appeals for the District of Columbia.

The said Court of Appeals erred in affirming the order of the Board of Tax Appeals and entering judgment in favor of the Commissioner of Internal Revenue at No. 7829, for the reason that the interest on the bond and mortgage in this case was payable to a domestic corporation, and St. Francis Hospital was not required to withhold any portion of the same, or pay any tax on account of such interest.

Summary of Argument.

It is conceded that the loan in this case was by the Union Trust Company originally and that under the bond and mortgage the interest was payable to a domestic corpora-

tion and no "withholding" required. The decision of the Court is based upon a "Declaration of Trust" executed by the mortgagee subsequent to the original mortgage setting forth that the mortgage was held in trust for several estates interested therein to the extent of the contribution of each toward the principal thereof as shown by the books of the trust company. This declaration does not specify any estates or any amounts. Even if the "Declaration of Trust" could be considered as an assignment, as it would involve the splitting up of the mortgage into numerous small amounts for numerous assignees, it would not be valid as against the mortgagor without the consent of the mortgagor, and the interest and principal would still be payable in one sum to the mortgagee.

However, the Declaration of Trust is simply a statement that the funds of various estates for which the trust company is fiduciary are from time to time invested in said mortgage as a mortgage pool, no part thereof being held except by the trust company in its own right and the trust company as fiduciary for such estates. As such fiduciary it alone would have the right to collect the interest and principal and the beneficiaries or other persons interested in said various estates would have no right to collect either the interest or principal and the interest would still be "payable to" the Union Trust Company.

The holding or the investment of funds of estates by fiduciaries in a pool mortgage or mortgages is governed by the Pennsylvania Act of 1929 which provides that no estate shall have any ownership in any such bond or mortgage and that the trust company shall have a right to retake any bonds or mortgages from the pool and to substitute other bonds and mortgages therefor. Under this act even the various estates have no interest in any such mortgage and of course, the individuals to whom such estate may be ultimately distributed would have no such interest, the right

of any estate in such pool mortgage being the right to participate pro rata with the other estates in the income and ultimately in the liquidation of the principal.

The interest involved here therefore was payable only to the original mortgagee. No other person had any right to proceed for the collection of the same and no other payment would have been possible either as a matter of law or as a matter of practical business dealing.

ARGUMENT.

An examination of the Act relating to "withholding" shows that it provides for such withholding where such interest is "*payable to* an individual, a partnership, or a foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein." As the Union Trust Company is a domestic corporation and has an office in Pittsburgh, Pennsylvania, it is evident that this legislation does not apply. Even in the case of a foreign corporation if it has an office in the United States or is engaged in business here no withholding is required. The evident intent was that in the case of a domestic corporation or a foreign corporation having an office or place of business here, the Internal Revenue Department could deal with such corporation without any difficulty; and that any withholding from interest or other sums due such corporations was not necessary to insure the collection of tax, and would impose an unnecessary burden upon the person paying the same.

To Whom Was Interest Payable?

The real question is: *To whom was the interest payable?* It will be noted that this is not a bond issue, but a single bond accompanied by a mortgage given for a loan made by the Union Trust Company to the hospital.

Under the admitted facts in this case the interest was "payable to" the Union Trust Company. It sent out the usual notice as to the payment of the interest semi-annually, and the interest was actually paid to it. No assignment or transfer of the mortgage was made; no notice was ever given to St. Francis Hospital that the mortgage was held other than by the Union Trust Company; and accordingly it was *payable to* and actually paid to a domestic corporation. Under the facts as set forth in the stipulation, it would have been impossible for the hospital to have paid the interest in any other way. If the hospital had actual notice of the so-called "Declaration of Trust" it could not have made distribution of the interest among the various estates. The "Declaration of Trust" does not specify any of them or indicate the extent to which the funds of said estates had been invested in the principal of said mortgage; even if we did not have the important circumstance that in all cases they were "the several estates" for which the Union Trust Company was fiduciary. The investments of the various estates change from time to time, as a minor became of age, or funds are necessary for his education; or under a trust various amounts became payable to various beneficiaries; so that the estates participating in the income from this mortgage were changing frequently, and possibly even from day to day.

However, the real question is—*To Whom was the interest "payable"*? Congress did not impose on the payer of the interest the duty of deciding the ultimate beneficiary, or the person who might have an equitable, remote or contingent estate. It knew that for his own protection, the obligor or mortgagor would have to determine the person to whom the interest was legally payable; and it made this simple fact the test of his liability to withhold the tax thereon. The same phraseology is used in the Act as to an

obligor *with no covenant* as in the present situation when we have such a covenant. Even in the present case the petitioner's covenant is limited to 2% and in the case of a foreign corporation the withholding required is 12%. Obviously it is necessary for the protection of the obligor that he know the amount to be withheld *at or before the time of payment.* Information as to any equitable or other interest in the obligation acquired *after* the payment had been made would be useless, and accordingly Congress fixed the test as the time of payment and the person to whom the interest was payable.

If the "Declaration of Trust" Constituted an Assignment.

It is the position of the hospital here that even if the so-called "Declaration of Trust" constituted an assignment of various interests or shares in the mortgage to the various estates designated upon the books of the trust company, it did not change the status of the parties here and the interest would still be "payable to" the Union Trust Company. It is conceded that the mortgage here was subject to assignment as a whole to one particular assignee, but the Union Trust Company as mortgagee had no right to split it up into numerous fragments and transfer title to these fragments to numerous estates or individuals so that an obligation would be imposed upon the hospital to pay the pro rata amount of interest to each of these numerous assignees. In the present case, for instance, there were in excess of 100 different estates which participated in this mortgage in varying amounts at various times. The rule as to this is well established in Pennsylvania. The question was before the Supreme Court of Pennsylvania, in the case of *Gordon, Secretary of Banking* v. *Hartford Sterling Company, et al.,* 319 Pa. 174, 179 Atl. Rep. 234, decided

May 27, 1935. In this case the Supreme Court held as set forth in 179 Atl. Rep. at page 236:

> "The assignment was for a part of the claim recoverable under the insurance policies. It was a partial assignment. We have early held that partial assignments are not binding unless they have been assented to by the debtor. Jermyn *v.* Moffitt, 75 Pa. 399; Philadelphia's Appeal, 86 Pa. 179; Geist's Appeal, 104 Pa. 351; Vetter *v.* Meadville, 236 Pa. 563, 567, 85 A. 19; Wells *v.* Philadelphia, 270 Pa. 42, 112 A. 867. The reason advanced is that a creditor should not be permitted to split up a single cause of action into many without the assent of the debtor; to do so subjects the debtor to embarrassments, responsibilities, and multiplicity of suits not contemplated in his original undertaking. It was held in Jermyn *v.* Moffitt, supra, that the assignment of part of a debt will not bind the debtor, either in equity or at law, nor deprive him of the right to pay the whole to the assignor, even after notice that a part has been transferred to the assignee. This latter principle was emphasized in Geist's Appeal, supra, where an attempt was made, through partial assignments, to lay hold of a fund held by the city of Pittsburgh for one of its creditors. The creditor made an assignment for the benefit for creditors; his assignee disregarded the claims of the partial assignees and collected the debt from the city; we held that the partial assignments did not bind the fund or any part of it. Therefore, where an assignor assigns a part of his claim, he is still the principal creditor and retains control of the claim unless the debtor accepts the assignee as a new creditor to the amount of the assignment."

One of the "embarrassments and responsibilities" which would result to the debtor from assignments of parts of the mortgage is the possible liability for income tax which is being asserted in this proceeding by the Commissioner of Internal Revenue.

The same question was before the Supreme Court of Pennsylvania in the case of *Vetter for use of Pittsburgh Buffalo Company* v. *Meadville,* 236 Pa. 563; 85 Atl. 19, where a partial assignment of a claim against the city of Meadville had been made and assented to by the City Treasurer. The Court held that the consent of the City Treasurer to the assignment was not binding upon the city and therefore the partial assignment could not be enforced against the city. The syllabus of the case as set forth at 236 Pa. 563 is as follows:

> "No suit can be maintained on a partial assignment of a debt unless it appears that the debtor assented to the assignment.
>
> An assignment by a city contractor of a portion of his claim against the city, and the assent to the assignment by the city treasurer, cannot be made a basis of an action against the city, unless it appears by the plaintiff's case that the city treasurer had authority to assent to the assignment on behalf of the city. No such authority is implied from his office."

The question of the application of this principle to a mortgage was before the Superior Court of Pennsylvania in the case of *Eldredge* v. *Eldredge, et al.,* 128 Pa. Superior 284; 194 Atl. Rep. 306.

The Superior Court said as set forth in 194 Atl. Rep., 310:

> "Complainant sought to have an award made from a 5/18 interest in a mortgage which her husband inherited from his parents * * * The mortgagors unless they have consented to do so, cannot be compelled to pay the mortgage debt in fractional shares to a number of people to whom the mortgage was not originally given. Concrete Form Co. *v.* W. T. Grange Construction Co., 320 Pa., 205, 208; 181 A. 589; Gordon *v.* Hartford Sterling Co., 319 Pa. 174, 177, 178, 179 A. 234, and cases cited therein."

Under the ruling in these cases it is apparent that without the express consent of the hospital it could not be required by any assignment or other act of the Union Trust Company to pay either the principal or interest of this mortgage in numerous parts to numerous assignees of portions thereof, and accordingly that whatever may be the effect of the so-called "Declaration of Trust" in this case, it would not change the legal status of the hospital; and so far as the hospital was concerned, the interest on the mortgage was still "payable to" the Union Trust Company.

The Interest Payable to the Union Trust Company and Actually Paid to It in Its Own Right or as Fiduciary.

It is the contention of the Commissioner, however, that because of the "Declaration of Trust", the estates acquired such rights in the mortgage that the various portions of interest thereon were "payable to" such various estates. Under the income tax legislation a fiduciary is treated as a tax payer representing the particular estate.

Under the stipulation of facts in this case, and the so-called "Declaration of Trust", Exhibit A, the Union Trust Company was *fiduciary* and the bond and mortgage held by it "in trust for the several estates interested therein to the extent of the contribution of each of said trust estates towards the principal thereof", so that there can be no question about the fiduciary character of the holding by the Union Trust Company for any portions of the bond and mortgage, which it did not hold in its own right.

As such fiduciary the Union Trust Company was under the obligation to make a return and subject to all the provisions of the law applicable to individuals. The income tax legislation very properly considers the fiduciary as the legal receiver of income accruing to an estate under its charge and control; and not the ultimate beneficiaries,

who may or may not receive the income depending upon the expenditures for administration, the claims of creditors, or other matters which may properly come before the courts on the final distribution. This is in accordance with the rulings of the courts as to the rights, powers and duties of fiduciaries. Under the Pennsylvania law, (and it is a principle of universal application), as it is set forth in Vale's Pennsylvania Digest, Vol. 16, Section 153, (1939 Edition), "The title to personal property of a decedent vests in the personal representative until distributed."

In a recent case before the Court of Common Pleas of Schuylkill County, Penna., *Bechman, Secretary of Banking* v. *Adams,* and reported in 36 District & County Reports, page 479, where a certificate for 8 shares of a bank's stock was issued to "Thomas N. Haesler, Guardian for Marvin L. Adams", it was held that after the minor had come of age he was not liable for an assessment made against the stock of the bank for the reason *that the title thereto did not vest in him until the certificate was actually endorsed and delivered or a separate assignment thereof executed.*

Likewise in the case of *Oudry-Davis* v. *Findley,* 64 Penna. Superior Court, 92, the Superior Court said, page 94:

> "It is a well recognized rule that debts due a decedent must be collected by his personal representatives. no one else unless in exceptional cases has any right to bring suit and enforce payment."

This situation is summed up in the Prentice-Hall Service, Vol. 2, page 18239, Section 18324, as follows:

> "The application of the withholding provisions of the statute to the income of a trust depends on the status of the fiduciary and not the creator or the beneficiaries thereof."

It is apparent, therefore, that even where a mortgage is held by a fiduciary expressly for a particular estate, the ultimate beneficiaries have no direct interest in the mortgage or any control over the disposition or collection of the same. The fiduciary alone has the right to collect it, to sell it, to bring suit and to enter satisfaction when it has been paid, *and it is payable only to the fiduciary.* The action of the fiduciary in any of these matters protects the person paying; the ultimate beneficiaries cannot interfere with it, and have no right except to proceed against the fiduciary for any negligence in the performance of these various duties. Therefore, even if this mortgage had been held by the Union Trust Company as guardian, executor or trustee in a particular estate, the interest still would be "payable to" the Union Trust Company, a domestic corporation, and no other payment would protect the hospital under its bond and mortgage.

The Act of Pennsylvania Governing Participation Mortgages.

However, in this case it was not held by the Trust Company as Trustee for any designated estate. It simply represented an investment pool which was used for the funds in numerous estates, both the estates and the mortgages therein changing from time to time and representing a sort of revolving fund both as to the estates and as to mortgage investments. It is an arrangement made in pursuance of the Act of Assembly of Pennsylvania which has been amended from time to time, the particular Act in force at the time the mortgage and so-called "Declaration of Trust" were executed being the Act of April 11, 1929, P. L. 512, which provides in substance that trust companies shall keep all trust funds separate and apart,

> "And provided further, That said companies may assign to their various trust estates participation in a

> general trust fund of mortgages upon real estate securing bonds, in which case it shall be a sufficient compliance with the provisions of this section for the company to designate clearly on its records the bonds and mortgages composing such general trust fund, the names of the trust estates participating therein, and the amounts of the respective participations; and in such cases *no estate so participating shall be deemed to have individual ownership in any bond* and mortgage in such fund, and the company shall have the right at any time to *repurchase at market value but not less than face value any such bonds and mortgages from such fund,* with the right to *substitute therefor other bonds and mortgages.*"

The act uses the word "assign", but it is not intended in the sense of a transfer of title, but rather as the designation or setting apart of a particular thing. The dictionary, in addition to the meaning of a transfer, specifies other definitions as follows, "to allot—to designate or appoint for a particular purpose—to fix or specify." The word "assign" could not have been used in the sense of "transfer" because the Act provides, "No estate so participating shall be deemed to have individual ownership in any bond and mortgage in such fund", followed by the further provision that the trust company shall have the right to repurchase any mortgage "from such fund" and also the right "to substitute therefor other bonds and mortgages." It is obvious that the trust company in this case did what the Act of Assembly contemplated—designated or allocated portions of this mortgage as representing for the time being investments of various estates for which it was fiduciary. Under the express phraseology of the Act, however, "no estate so participating shall be deemed to have individual ownership" and the trust company retained the legal right to take back any portion of the mortgage or to "substitute" other bonds and mortgages therefor. These provisions are entirely in-

consistent with the vesting of any title in the various estates.

Under this legislation the Trust Company is treated as owning and controlling the mortgage or mortgages in the fund or mortgage pool, and the various estates as having no interest whatever therein, but only an equitable participation in the entire pool to the extent of the temporary investment of funds. No estate has any ownership in any bond or mortgage, as the Act specifically states, and the "right to repurchase" under the Act is not to repurchase from any estate or estates, but "From such fund" or mortgage pool. The trust company has also the right to remove any mortgages from the pool and substitute other mortgages therefor, dealing only with its trust department, which owns and controls the pool and not with the estates which may be "participating therein." Accordingly, it is apparent that no estate which may be participating in the mortgage pool or fund has even an equitable interest in any mortgage therein. Its rights are even less than those of a stockholder of a corporation who, of course, has no particular interest in any specific asset of the corporation, the title to such assets being in the corporation itself; and no one would suggest for a moment that a person paying interest to a domestic corporation would come under the provisions of the "withholding" legislation because some of the stockholders of that corporation were individuals or partnerships. The effect of this law of Pennsylvania was before the Court of Common Pleas of Philadelphia County, Pennsylvania in *Blair* v. *Pennsylvania Company, etc.*, 24 District and County Reports, 490. Defendant had held a mortgage for four estates of which it was fiduciary, foreclosed the mortgage and purchased the property as Trustee. The plaintiff, who was a beneficiary in one of said estates, filed a bill in equity to compel partition on the theory that he had an interest in this mortgage, and therefore an interest in the real estate, which was the result of a foreclosure of the mortgage. The

court held that notwithstanding the fact that there was in the case a single mortgage, it came within the provisions of the legislation cited above, and the court said:

> "One of the purposes of the act was to segregate control of the mortgage from the beneficiaries and impose on the trustee the duty to protect the former's investment. The act specifically states that the cestuis que trustent shall have no individual ownership in the bond and mortgage and it necessarily follows that on foreclosure this separation of legal and beneficial interest continues until the property has been liquidated. To hold that the trust ceases on the foreclosure of the mortgage would be to defeat the purposes of the act which gives the trustee the entire control in the handling of this particular investment. The act, in effect, authorizes the creation of a special trust which cannot be held executed until its purposes are accomplished."

A similar question was before the Supreme Court of Pennsylvania in *Guthrie's Estate*, 320 Pa., 530, 182 Atl. Rep. 248, where the question was raised that as there was only a single mortgage, it did not come within the Act of 1925, amended in 1929, which we have heretofore set forth in this brief. The Supreme Court in its opinion as set forth in 182 Atl. Rep., 250, said:

> "It is plain that the Legislature saw fit to permit an exception to the rule in the case of participation in a pool of a number of mortgages because such pools could not be successfully operated otherwise. It is equally plain that the exception is no less necessary to the successful operation of participations in single mortgages, and that the legislative intention must therefore have been to include the latter within the exception. The distinction is between mortgages in which participation is allotted and those in which there is no participation. The single mortgage participation scheme is generically not distinguishable from that in which the participation is in a larger pool."

It is apparent therefore, that whether the mortgage in this case constituted a single pool, or was part of a pool composed of several mortgages, is immaterial. The effect of the legislation is exactly the same. It is also apparent that no estate which may at any time have had participation in this mortgage acquired any ownership therein; that the title to said mortgage remained at all times in the Union Trust Company with the absolute control thereof, with the right to take it back from the trust department pool into the commercial or individual ownership of the bank and with the right to substitute other mortgages therefor. Accordingly, there seems to be no doubt that the interest in this case was "payable to" the Union Trust Company, a domestic corporation and that the "withholding" legislation does not apply.

Respectfully submitted,

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